Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-1397-00
AJMandell

date:

to: Chief, Examination Division, Brooklyn
Attn: Catherine Manzella

from: District Counsel, Brooklyn

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subject: [redacted]
U.I.L. 263A.02-03; 174.00-00

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Issue:

1. Whether the designer fees paid by the taxpayer in the fiscal years ending April 30, [redacted], April 30, [redacted] and April 30, [redacted] should be capitalized pursuant to I.R.C. section 263A, or whether the fees are currently deductible as research and experimental expenditures pursuant to section 174?

Facts:

The facts, as we understand them from the information you provided, are as follows:

The taxpayer designs shoes and has them produced in Italy. The shoes are eventually sold in the United States. The fees at issue were used to make design changes in the shoes to keep up with changing social trends. The taxpayer would look at [redacted] of different designs in a given year, but would only implement about [redacted] of the designs. Apparently, no significant or innovative changes were made to the shoes. The design changes had more to do with keeping up with fashion trends then improving the product.[1]

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[1]Typical design changes would include increasing or decreasing the length or width of the heel.

It is the taxpayer's position that the costs at issue are research and experimentation costs and are therefore fully deductible in the years paid.

Discussion:

I.R.C. section 263A(a)(1) provides in pertinent part that in the case of any property to which the section applies[2], any costs described in paragraph (2) shall be included in inventory costs in the case of property which is inventory in the hands of the taxpayer and shall be capitalized in the case of other property.[3]

Section 263A(a)(2) provides that the costs described in this paragraph are the direct costs of the property and such property's proper share of those indirect costs part or all of which are allocable to such property.

Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced). Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale.[4] Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Treas. Reg. section 1.263A-1(e)(3)(i).

Indirect costs that are required to be capitalized, to the extent they are properly allocable to property produced, include engineering and design costs. Engineering and design costs include pre-production costs, such as costs attributable to research, experimental, engineering, and design activities to the extent that such amounts are not research and experimental expenditures as described in section 174 and the regulations thereunder. Treas. Reg. section 1.263A-1(e)(3)(ii)(P).

Therefore, it appears that pursuant to section 263A the expenses in question would have to be capitalized as indirect costs

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[2]Pursuant to 263A(b), section 263A applies to property produced by the taxpayer and property acquired for resale.

[3]Section 263A was enacted by the 1986 Act, section 803(a), 1986-3 (Vol. 1) C.B. 267. In general, section 263A is effective for costs incurred after December 31, 1986.

[4]The term "produce" includes construct, build, install, manufacture, develop or improve. Section 263A(g)(1).

allocable to property produced by the taxpayer unless the costs are research and experimental expenditures pursuant to section 174.

Section 174 provides that a deduction shall be allowed for research and experimental expenditures which are paid or incurred during the taxable year in connection with the taxpayer's trade or business.[5]

The term research or experimental expenditures, as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business with represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. Expenditures represent research and development in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development of improvement of a product. Treas. Reg. section 1.174-2(a)(1).[6] Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Tech. Adv. Mem. 199927001 (March 4, 1999).

In considering the definition of section 174, the Tax Court found it to be "consistent with the intent of the statute to limit deductions to those expenditures of an investigative nature expended in developing the concept of a model or product." Mayrath v. Commissioner, 41 T.C. 582, 590 (1964); aff'd. without discussion on the issue; 357 F.2d 209 (5th Cir. 1966).

While, in a sense, the amounts in question were paid by the taxpayer to develop a new version of an existing product, we do not

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[5]It is clear that the intent of Congress in enacting section 174 was to give taxpayers the option of treating research and experimentation expenditures in much the same manner as ordinary and necessary business expenses deductible under section 162 and to encourage taxpayers to carry on research and experimentation. H.R. 8300 (Pub. L. 591), 83d Cong. 2d Sess., p.33 (1954); Mayrath v. Commissioner, 41 T.C. 582 (1964).

[6]The regulations as amended apply to taxable years beginning after October 3, 1994. Because the 1994 amendments merely clarify the existing definition of research or experimental expenditures, however, return positions for years prior to October 4, 1994 that are consistent with the amendments will be recognized as consistent with the final regulations in effect for those years. Tech. Adv. Mem. 199927001 (March 4, 1999); Norwest Corporation and Subsidiaries v. Commissioner, 110 T.C. 454 (1998).

believe that the amounts expended by the taxpayer represent research and development costs in the experimental or laboratory sense. Shoes, and the technology required to produce them, have been in existence for a long time. The taxpayer did not improve on such technology, it merely produced a slightly different type of shoe. Crouch v. Commissioner, T.C.Memo. 1990-309. The taxpayer apparently did not make any significant changes to the shoes, and clearly did not make any changes in the scientific or laboratory sense. The design changes resulted in only minor changes to the shoes to keep up with social trends.

We therefore agree that the expenses at issue do not qualify as research and experimental expenditures under section 174, and therefore they should be capitalized pursuant to section 263A.

If you have any additional questions, please call the undersigned at (516) 688-1701.

This opinion is based upon the facts set forth herein. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

JODY TANCER
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Brooklyn

By: _____
ANDREW J. MANDELL
Attorney